

***United States Court of Appeals
for the Second Circuit***



**APPELLANT'S
BRIEF**

[CORRECTED COPY]

77-1342

To be argued by
DAVID A. CUTNER

United States Court of Appeals
FOR THE SECOND CIRCUIT

Docket No. 77-1342

UNITED STATES OF AMERICA,
—v.—
Appellant,

DOUGLAS P. FIELDS, FREDERICK M. FRIEDMAN,
PETER S. DAVIS, ALAN E. SANDBERG, and
ERIC BERGE,
Defendants-Appellees.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

BRIEF FOR THE UNITED STATES OF AMERICA

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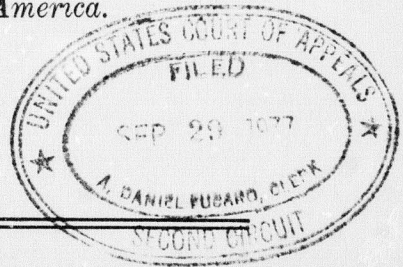


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DAVIS, ALAN E. SANDBERG, and ERIC BERGE,

Defendants-Appellees.

BRIEF FOR THE UNITED STATES OF AMERICA

Preliminary Statement

The United States of America appeals, pursuant to 18 U.S.C. § 2731,* from a pre-trial order entered in the United States District Court for the Southern District of New York on June 3, 1977 by the Honorable Charles S. Haight, Jr., United States District Judge, striking paragraphs 10(d)-(h) and 11(e) and dismissing Counts Four through Eleven of Indictment 76 Cr. 1022 (CSH), and from an order entered July 7, 1977 denying reargument. The District Court's orders followed an eleven day evidentiary hearing and were premised on a finding

* See *United States v. Alberti*, Dkt. No. 76-1543, slip op. 5505, 5508-11 (2d Cir., Aug. 24, 1977).

that representatives of the Securities and Exchange Commission ("SEC") had engaged in misleading and wrongful conduct in obtaining a settlement of a civil action brought by the SEC against the defendants, and on alternative grounds discussed *infra*.

Indictment 76 Cr. 1022, filed on November 8, 1976, charged defendants Douglas P. Fields, Frederick M. Friedman, Peter S. Davis, Alan E. Sandberg and Eric Berge with the following offenses:

Count	Defendant	Violation	Statute
1	Fields, Friedman, Davis	Conspiracy to violate securities laws	18 U.S.C. § 371
2	Fields, Friedman, Davis	Securities fraud	15 U.S.C. § 77q(a)
3	Fields, Friedman, Davis	Filing a false prospectus with the SEC	18 U.S.C. § 1001
4	Fields, Friedman, Davis	Soliciting proxies with false proxy statements	15 U.S.C. § 78n(a)
5	Fields, Friedman, Berge, Davis	Soliciting proxies with false proxy statements	15 U.S.C. § 78n(a)
6	Friedman, Sandberg	Wire fraud	18 U.S.C. § 1343
7—10	Friedman, Sandberg	Mail fraud	18 U.S.C. § 1341
11	Friedman	Soliciting proxies with false proxy statements	15 U.S.C. § 78n(a)
12	Berge	False testimony before the SEC	18 U.S.C. § 1001

The orders appealed from provide for dismissal of all charges against defendants Friedman, Davis, and Sandberg, and a majority of the allegations against Fields and Berge. Trial of the remaining charges against Fields and Berge has been stayed pending this appeal.

Summary of the Government's Position

In the proceedings below, the defendants sought dismissal of the Indictment on the ground that the SEC had breached a promise not to refer their case to the Department of Justice for criminal prosecution.* The District Judge ordered an evidentiary hearing on this claim and, after listening to a great deal of conflicting testimony, concluded that no such promise had been made to the defendants. The District Court did find, however, that representatives of the SEC had, in connection with their efforts to obtain a settlement of their civil action against the defendants, wrongfully concealed from the defendants' attorneys the fact that an informal criminal reference had earlier been made to the United States Attorney's Office.

While remaining firmly convinced that the District Court was in error in resolving against the Government close questions of credibility which the Judge himself

* Pursuant to statute and regulation, the SEC is authorized to bring to the attention of the Department of Justice any case as to which it believes prosecution may be warranted. 15 U.S.C. §§ 77t (b), 78r (e); 17 C.F.R. § 202.5 (b). The Commissioners have delegated this function to the divisions and regional offices of the SEC. 15 U.S.C. § 78d-1(a); SEC Manual of Administrative Regulations, § 171. In recent years, virtually all criminal references have been made "informally" by the regional offices to the local United States Attorney, rather than "formally" by the Commissioners to the Department of Justice in Washington, D.C. (Appendix at 56-57) (The Appendix is referred to hereinafter as "App.").

viewed as difficult (App. 50),* we recognize the limited role that this Court traditionally performs in reviewing factual findings by inferior courts. Accordingly, we are not seeking a review of the findings underlying the District Court's conclusion that the SEC representatives acted improperly.

What we do seek is a modification of the District Court's unprecedented and ill-considered decision to remedy what happened at the SEC by dismissing the serious criminal charges brought against the defendants by the Grand Jury and the United States Attorney's Office. Since the prosecution was uninvolved in, and unaffected by, the improper conduct, and since the defendants were not prejudiced in any way in the instant criminal case, we believe that the appropriate remedy would have been (and still is) an order setting aside, with prejudice, the defendants' obligations further to perform pursuant to the terms of the civil settlement reached between the SEC and the defendants.** Such a remedy, unlike the one ordered below, would have been truly remedial in nature rather than an undeserved windfall to the defendants.*** And instead of unfairly punishing the Grand Jury and the public it represents, an order

* For example, faced with a direct conflict between the testimony of two SEC attorneys that they advised defense counsel that there was "no deal on criminal," and defense counsel's testimony that no such statement had been made, the District Court, with difficulty, declined to credit the SEC lawyers' testimony. (App. 49-50).

** In order to avoid any question as to whether the District Court had the power to grant such relief against the SEC, which of course was not a party to the proceeding, the SEC consented to vacatur of the judgments. (App. 128).

*** While defendants of course have not pleaded guilty, defense counsel have freely conceded the culpability of defendants Fields, Friedman, and Davis:

[Cross-examination of Milton S. Gould, counsel for Fields, Friedman, and Davis during the SEC case.]

[Footnote continued on following page]

vacating the civil judgments would have struck directly at the SEC and thus have been more likely to act as a deterrent to future SEC misconduct. Finally, such an order would have taken into account the strong public interest in prosecuting these defendants for their blatant criminal conduct.

To lay the groundwork for our argument that the District Court's remedy must be modified, and that such a modification will provide defendants with complete and appropriate relief from the SEC's misconduct, we turn to a discussion of (i) the criminal charges against the defendants; (ii) the events which led up to the defendants' civil settlement with the SEC; (iii) the terms of the civil settlement and the results actually achieved by the settlement; and (iv) the District Court's opinion.

[Footnote continued from previous page.]

"Q. And you recognized Mr. Gould, that this was a serious case? A. Yes, sir.

Q. This was not a technical rule violation or anything of that sort? A. Correct.

Q. It was, in plain language, a case of stealing, isn't that so, Mr. Gould? A. I think that's right." (App. 351-52).

* * * * *

[Colloquy between Government Counsel and Louis Bender, attorney for Fields and Friedman in the instant criminal case.]

"MR. CUTNER: Your Honor, to me, there is an amazing inconsistency here. To my understanding, the defendants have not admitted any of the charges here—

MR. BENDER: That is not true.

MR. CUTNER: And indeed dispute the charges here.

MR. BENDER: That is not true ..." (Tr. 1127).

Statement of Facts

A. The Defendants' Fraudulent Conduct

The Indictment alleges a variety of fraud and federal securities law offenses arising essentially from four fraudulent transactions in which the defendants sought to enrich themselves at the expense of unsuspecting shareholders:

First, in March of 1971, defendants Fields and Friedman, both officers and directors of TDA Industries, Inc. ("TDA"), caused Westcalind Corp. ("Westcalind"), a TDA subsidiary, to pay a "finder's fee" of \$50,000, when no services of any kind were performed by the purported "finder," who served simply as the conduit for funds illegally siphoned off from the corporation for the personal benefit of Fields and Friedman. In this transaction, the "finder" remitted \$35,000 in cash to these two defendants and pocketed \$15,000 for his trouble. (This transaction is referred to hereinafter as the "Westcalind kickback.")

Second, in April and May of 1971, defendants Fields, Friedman, and Davis, the attorney for TDA, defrauded a group of TDA stockholders out of \$435,000. Defendants obtained this sum by refusing the request of these stockholders to "free-up" their lettered stock in TDA for sale on the open market, and falsely representing that the stock could only be transferred in a private placement. Then, these defendants arranged a private placement at a \$2 per share discount from market price, concealing from the selling stockholders that by pre-arrangement the shares would immediately hereafter be "freed up" and sold on the open market, and that 70% of the gross profits would be kicked back to the defendants. (These transactions are referred to hereinafter as the "ERD kickbacks.")

Third, in November 1971, defendant Fields made pay-offs to co-conspirators to induce them to purchase TDA stock on the open market immediately prior to a public secondary offering of TDA stock, for the purpose of artificially inflating the offering price.

Fourth, in February and March 1973, defendants Friedman and Sandberg caused TDA to pay another sham "finder's fee" of \$100,000 to their nominee who kicked back \$82,000 in cash to these defendants. (This transaction is referred to hereinafter as the "Eagle Roofing kickback.") *

B. The Events Leading to the Civil Settlement

1. Initial Contacts with the SEC.

During 1974, the Manhattan District Attorney's Office conducted an investigation into the payment of the phony \$50,000 and \$100,000 "finder's fees" paid by Westcalind

* These four fraudulent transactions relate to the counts of the Indictment as follows: in Counts One and Two, the Indictment charges that defendants Fields, Friedman, and Davis conspired to, and did in fact, commit a fraud in the sale of TDA stock at artificially high prices to the public. The means by which the fraud was carried out were the price manipulation scheme described above, and the circulation of an offering prospectus which failed to disclose the Westcalind kickback and the ERD kickbacks.

Similarly, Counts Three, Four, and Five charge that the same defendants (and Berge as to Count Five) filed a false offering prospectus with the SEC, and mailed false proxy solicitations to TDA and Westcalind shareholders, in that defendants did not disclose in these documents the Westcalind and ERD kickbacks and the price manipulation.

Counts Six through Eleven charge defendants Friedman and Sandberg with violations of the wire and mail fraud statutes arising from the Eagle Roofing kickback.

Finally, Count Twelve charges Berge with giving false sworn testimony to the SEC concerning the Westcalind kickback.

and TDA respectively (the Westcalind and Eagle Roofing kickbacks), and the purchase and re-sale of TDA restricted stock at a \$435,000 profit in April and May, 1971 (the ERD kickbacks). The targets of the District Attorney's investigation included TDA, Westcalind, Douglas Fields, Frederick Friedman and Peter Davis. In early January 1975, the District Attorney decided to bring the matter to the SEC's attention, and so advised defense counsel, who asked for the opportunity to bring the case to the SEC themselves. (App. 43, 567).

Defense counsel, Messrs. Milton Gould, Saul Streit, and Herbert Kantor, then recommended to their clients that it would be better to seize the initiative and bring the matter to the attention of the SEC before the District Attorney did so.* Although defense counsel recognized from the outset that the defendants' activities certainly constituted criminal offenses, they were hopeful that, by presenting the case to the SEC "on a silver platter," they could put together a package which might give them a good chance of talking the SEC out of a criminal reference to the Department of Justice. (App. 43-44, 308, 352).

The defendants accepted this advice and, through their counsel in January 1975, disclosed to the SEC the transactions then under investigation by the District Attorney. Defendants did not disclose at any time, however, their scheme to inflate artificially the price of TDA stock alleged in the Indictment. (App. 44-45).**

* Gould and Streit represented Fields, Friedman, and Davis; Kantor represented the two corporations.

** The SEC, during its investigation, independently uncovered some evidence which caused it to suspect a price manipulation scheme, but the evidence was insufficient to warrant a charge in the civil complaint. (App. 60).

At the outset, counsel for Davis conceded to the SEC that he had no hope of preserving Davis' right to practice law before the SEC and, indeed, had little hope of preserving Davis' membership in the Bar. Defense counsel's primary goals at the SEC were the avoidance of a criminal reference, and the continuance of Fields and Friedman as officers of TDA. (App. 46, 564).

In the ensuing months during the SEC investigation, defense counsel repeatedly expressed their objective of avoiding a criminal reference. The SEC attorneys did not respond in any way. (App. 46-50).

2. The SEC's Civil Complaint

On September 16, 1975, the SEC filed a complaint entitled *SEC v. TDA Industries, Inc., et al.*, 75 Civ. 4519, in the United States District Court for the Southern District of New York. The complaint named as defendants the two corporations (TDA and Westcalind) and the five individuals named in the instant Indictment. The complaint was based upon the fraudulent transactions that defense counsel had disclosed to the SEC in January 1975, *i.e.*, the phony \$50,000 and \$100,000 "finder's fees" (the Westcalind and Eagle Roofing kickbacks), and the \$435,000 stock fraud (the ERD kickbacks). (GX 19).

The SEC's complaint requested injunctive and other relief, including: (1) disgorgement of all funds fraudulently obtained from the corporations and their shareholders, *i.e.*, the "finder's fees" of \$50,000 and \$100,000, plus the \$435,000 profit on the sales of restricted stock; (2) appointment of a receiver for TDA and Westcalind; (3) a prohibition on Fields and Friedman serving as officers or directors of TDA or Westcalind; and (4) a prohibition on Fields and Friedman voting their TDA or Westcalind stock. (GX 19). An administrative

proceeding to disqualify defendant Davis, TDA's attorney, from practicing before the SEC was not commenced, since it was a foregone conclusion from the very beginning that Davis would have to give up that right. (App. 564).

By the time the SEC filed its complaint against defendants, they and their counsel assumed that they had a deal that the SEC would not bring the case to the attention of the United States Attorney if a consent judgment could be worked out, because SEC counsel had remained silent in the face of defense counsel's stated desire to avoid a criminal reference. Thereafter in September and October 1975, on two occasions, the SEC representatives maintained that silence when defense counsel indicated their understanding that an agreement not to make a criminal reference had actually been reached. In addition, in October 1975, an SEC attorney advised counsel for a prospective "outside" director that there would be no criminal reference. (App. 51-55).

Meanwhile, in September, October, and November, 1975, the same SEC attorney had called the United States Attorney's Office and informally suggested a criminal prosecution as soon as the civil case was completed, and on December 1, 1975, the SEC forwarded to the United States Attorney's Office copies of the papers filed in the civil case. (App. 55-56, 205).*

In the settlement negotiations occurring at this same time, the defendants were handicapped by the fact that, having disclosed to the SEC the violations upon which the

* The District Court rejected defendants' claim that it was improper for the SEC not to have utilized the so-called "formal" criminal reference procedure, and found that "the informal procedure is time-saving and the result of various practical considerations." (App. 68-69).

complaint was based, they were not in a position to testify in their own defense or indeed to present any substantive defense at all. Also, experienced counsel recognized that any testimony by the defendants might have had serious consequences in any future criminal proceeding. Due to their weak position, defense counsel sought only to salvage for Fields and Friedman the right to remain as officers of the corporations, and did not even attempt to negotiate a smaller monetary settlement. (App. 47, 354-55, 371, 573, 574).

On December 10 and 11, 1975, the SEC failed to disclose the fact that an informal criminal reference had already been made on December 1st, and obtained the consent of defendants Fields, Friedman, and Davis to a settlement which provided that Fields and Friedman could remain officers of TDA. (App. 117-18). As it turned out, the achievement of this goal placed them in a position virtually to nullify the civil penalties imposed by the other terms of the civil settlement.

C. The Settlement and What It Has Achieved

The settlement agreed to* provides for an injunction against the defendants from committing further violations and for (1) repayment by Fields, Friedman and Davis to TDA and Westcalind of the \$585,000 fraudulently obtained by them; and (2) a prohibition on Fields and

* Settlement discussions between the SEC and defendants Fields, Friedman, and Davis concluded on December 10 and 11, 1975 when each defendant signed a consent to entry of judgment, and a final judgment was entered against them in the District Court on February 5, 1976. Sandberg signed a consent on January 6, 1976, and a final judgment against him was entered on January 16, 1976. Berge signed his consent on February 10, 1976 and a final judgment was entered on February 23, 1976. (App. 150, 193, 200).

Friedman from serving as directors or voting their stock in TDA and Westcalind—but not from serving as officers of the corporations—for a period of two years. It was also agreed that Davis would resign from practicing law before the SEC, a result which Davis' own counsel regarded as inevitable from the very outset. More specifically as to the monetary liability, defendant Davis was obligated to pay approximately \$120,000 in two equal installments in August 1977 and August 1978. Fields and Friedman were obligated to pay the remaining \$465,000, but they received credits totalling \$142,250, representing \$70,000 in stock returned to TDA by defendant Sandberg and \$72,250 in currency (proceeds of the ERD kickbacks) which Fields and Friedman turned over to TDA in early 1975. Fields and Friedman were each to pay \$60,000 on January 2, 1977 and then pay the remaining \$202,750 by August 1978. (App. 150, 564).

Thus, if the unperformed portions of the civil consent judgments were to be vacated, Davis would be relieved of the obligation to pay \$60,000 of the \$120,000 for which he is liable.* Fields and Friedman would each be freed of the obligation to pay \$101,375, which represents more than 63% of each defendant's "out of pocket" liability under the consent judgments.

Moreover, the only "out of pocket" payments thus far made by Fields and Friedman—the \$60,000 each paid in January, 1977—has in reality been of no significance to them. This is so because, remaining as key officers of TDA and Westcalind, Fields and Friedman have been applauded by the TDA Board of Directors for having

* This assumes that Davis paid the \$60,000 due in August 1977 pursuant to the civil judgment.

"always acted with total integrity and selflessness in the Corporation's interest" (App. 188), and rewarded with substantial salary increases and bonuses. This extra remuneration more than defrayed the \$60,000 Fields and Friedman have each thus far been obligated to pay.*

The other relief consented to by Fields and Friedman has had only the slightest impact on them. Their voting rights have not, as a practical matter, been affected at all, since the shareholders of TDA have not been asked to vote on any subject at any time during 1975, 1976, or 1977. Nor has the two year ban on their serving as directors affected their positions within the corporation. Fields and Friedman remain the first and third highest paid executives, respectively.**

D. The District Court's Rulings

After the instant Indictment had been returned, the defendants moved prior to trial to dismiss the charges on the ground that the SEC had breached a promise not to refer the defendants' case to the Department of Justice for criminal prosecution.

* Remuneration to Fields and Friedman from TDA and Westcalind has been as follows:

	Salary year ended 6/30/75	Salary year ended 6/30/76	"One time" retroactive "cost of living" increase	Bonus 6/30/76
Fields	\$144,480	\$171,770	\$36,860	\$25,000
Friedman	\$102,000	\$108,552	\$36,860	\$25,000

(These figures do not even reflect contributions to pension and profit sharing plans of \$39,200 in fiscal 1975 and \$41,000 in fiscal 1976 for each defendant.) (App. 168-173).

** The second highest paid executive is Edward A. Lampert, the Executive Vice President, who took over Fields' position as Chairman of the Board. He earns \$50,973 less than Fields. (App. 168-173).

In an opinion filed June 3, 1977, the District Court rejected the theory initially advanced by the defendants, finding that the SEC had made no promise, express or implied, not to refer the case to the Department of Justice. (App. 62-66). However, the District Judge granted the defendants' motion with respect to a majority of the charges on the alternate theory that representatives of the SEC had wrongfully failed to disclose to defendants during the civil settlement negotiations that an informal criminal reference had already been made. (App. 70-72). Lacking any allegation or showing of prejudice in the criminal case,* and further lacking any specific legal authority for basing the dismissal of an indictment on defects in a civil proceeding, the Court invoked the "supervisory powers" doctrine, finding that "the administration of justice itself has been prejudiced, by inequitable behavior." (App. 77).

The essence of the Court's conclusions was as follows:

"The SEC's strategy of concealment led logically to non-disclosure of the fact that, on December 1, a criminal reference had actually been made. In the circumstances of the case, I conclude that principles of equity and fairness required the SEC representatives to advise defense counsel immediately that a criminal reference had been made. . . .

* * * * *

I do not hold that SEC negotiators are obligated, in all circumstances, to keep defense counsel *au courant* as to their tentative or preliminary

* Fields, Friedman, Davis, and Sandberg asserted the Fifth Amendment at the SEC. Berge, who agreed to be examined, gave false, exculpatory testimony, which is the subject of Count Twelve. None of defendants provided privileged documents of any kind.

thoughts on a *future* criminal reference; or that equally preliminary conversations between the SEC and a United States Attorney must be promptly revealed. What I do hold is that, in the circumstances of this case, the SEC's nondisclosure of the *present fact* of a criminal reference, viewed in the context of all that had gone before, was inequitable and wrong." (App. 70, 72) (emphasis in original) (footnote omitted).*

After finding this SEC misconduct, the District Court mentioned three possible remedies:

"(1) An admonishment to the SEC, intended to prevent future occurrences, but unaccompanied by any sanction.

(2) Permitting the defendants to reopen the consent judgments entered in the civil suit, but taking no action with respect to the indictment. That is the course urged upon the Court by the Government, in the event that impropriety is found.

(3) Dismissing the indictment in its entirety. That is the course urged upon the Court by the defendants, who seek to embrace the confines of the remedy to include transactions not referred to in the civil complaint or settlement." (App. 73).

* We think it particularly important to note that the SEC's duty to disclose the criminal reference arose *after* the reference had been made. Thus, it is clear that, even if the SEC had made such disclosure to the defendants, they could not have avoided the criminal reference and the Indictment which inevitably followed. Therefore, the real issue presented here—which the District Court *did not* even address—is whether the defendants, armed with knowledge of the criminal reference, would have been able to negotiate a better civil settlement.

The District Judge quickly dismissed the first alternative, finding that an admonishment unaccompanied by any sanction would be inadequate to deter such conduct by the SEC in the future. The Judge's rejection of any reopening of the civil consent judgment was explained as follows:

"Nor can I agree with the Government that a reopening of the civil consent judgments constitutes a sufficient remedy. The guiding principles are those of equity. If the consent judgments are vacated, and all civil sanctions removed, TDA shareholders will be required to restore to these particular defendants monies which the defendants were obliged, by the civil settlement, to disgorge. That is not, in the circumstances of the case, an appealing resolution. Furthermore, it is impossible, by reopening the civil consent judgments, to restore the individuals concerned to the positions in which they found themselves at the time of the non-disclosure of the criminal reference, in December of 1975, and the subsequent execution of the consent judgments. That is particularly true in the case of defendant Davis, who as noted resigned from his law partnership and saw his practice come to a virtual end, as the direct consequence of the SEC's bargained-for withdrawal of Davis from practice before the Commission. The same situation arises, albeit with lesser dramatic force, in respect of the activities which the other defendants were obliged to give up as a result of the consent judgments. I conclude that reopening of the civil suit is not a sufficient remedy." (App. 74-75).

Without any explanation whatever, the District Judge also rejected the suggestion that, even if disclosure of the criminal reference had been made by the SEC, the de-

fendants would have had no alternative but to consent to similar relief. Surprisingly, the Court estopped "the SEC" from making this argument, apparently temporarily losing sight of the fact that "the SEC" was not a party to the proceeding. (App. 58-59).

Turning to the third alternative, the Court, applying what it perceived to be equitable principles, agreed with "reluctance" to dismiss those charges arising out of the transactions revealed to the SEC by the defendants. (App. 76-77).

The District Judge then went on to discuss various alternative grounds for dismissal of certain of the charges. These portions of the Court's opinion are fully discussed in the Argument section of this Brief, at pp. 35-47, *infra*.

ARGUMENT

POINT I

Dismissal of charges contained in the Indictment was totally unwarranted and improper.

There is concededly a strong public interest in deterring misconduct by any government agency. There is as well a strong public interest in prosecuting defendants for violations of the criminal laws, particularly when such violations involve aggravated and extensive fraudulent activity. The District Judge recognized the validity of both of these interests and, finding himself "in a veritable dilemma when [his] choice [was] between vindicating a rule by sanction and allowing a possibly guilty person to escape" (App. 76), reluctantly chose the extreme sanction of dismissing virtually all of the charges in the Indictment. We disagree with, and appeal from, the

District Court's decision, because there was no such dilemma in this case.

Rather than dismiss these serious criminal charges, the District Court should have remedied the SEC's misconduct by modifying the terms of the civil consent judgment so as to approximate the terms that would have obtained had the SEC informed the defendants that a criminal reference had been made. This alternative sanction would have permitted the well-warranted prosecution of these defendants and functioned as appropriate and complete relief for any injury suffered by the defendants in the civil case at the hands of the SEC.*

In fashioning a remedy in this case, the District Court purported to rely on principles of equity. (App. 74). In a number of recent cases, the Supreme Court has had occasion to reaffirm the settled principles governing the use of equitable remedies. *E.g.*, *Dayton Board of Education v. Brinkman*, 45 U.S.L.W. 4910 (U.S., June 27, 1977); *Milliken v. Bradley*, 45 U.S.L.W. 4873 (U.S., June 27, 1977); *Hills v. Gatreaux*, 425 U.S. 284 (1976); *Franks v. Bowman Transportation Co.*, 424 U.S. 747 (1976); *Milliken v. Bradley*, 418 U.S. 717 (1974); *Swann v. Board of Education*, 402 U.S. 1 (1971).** Even a cursory review of the principles of equitable remedies demonstrates that the District Court's decision to dismiss the criminal

* As already mentioned, no prejudice in the instant criminal case was even claimed. See p. 14, *supra*.

** While most of these cases involve desegregation decrees directed at state and local governmental units in which considerations of federalism—not present here—play a part, they are nonetheless direct authority for the instant case, since they are based on general equitable principles. *Brown v. Board of Education*, 349 U.S. 294, 300 (1955); *Milliken v. Bradley*, *supra*, 45 U.S.L.W. at 4877.

charges contained in the Indictment violates virtually all of these principles.*

A. The District Court's Order Violates the Principle That Equitable Relief Should As Nearly As Possible Be Remedial

The first principle of equitable remedies violated by the District Court's order is that such remedies must be truly "remedial in nature," that is, they must be "designed as nearly as possible 'to restore the victims of [illegal] . . . conduct to the position they would have occupied in the absence of such conduct.'" *Milliken v. Bradley, supra*, 45 U.S.L.W. at 4877. The dismissal of the criminal charges ordered below is plainly not remedial in nature.** Dismissal permits the defendants totally to

* While the Supreme Court has indicated that lower federal courts are imbued with "broad and flexible equity powers," *Milliken v. Bradley, supra*, 45 U.S.L.W. at 4879, the Court has not hesitated to review and reverse remedies that violate established principles of equitable relief. *E.g., Milliken v. Bradley*, 418 U.S. 717, 744-47, 752-53 (1974).

** The District Court's reliance on the "supervisory power" doctrine to justify dismissal of the Indictment is misplaced, since that doctrine gives only the power to correct deficiencies in the operation of the federal criminal justice system, without implying the propriety of any particular remedy. Indeed, an analysis of the cases relied on by the District Court below demonstrates that, in applying the doctrine, the courts have been careful not to grant relief in excess of that required to restore defendants to the position they would have occupied absent the impropriety.

Thus, where alternative—remedial—relief can be framed, the courts have not utilized the extreme sanction of dismissal of the indictment. In *Santobello v. New York*, 404 U.S. 257, 262-63 (1971), relied upon by the District Court, the defendant entered into a plea bargain which included a promise from the prosecutor that he would make no recommendation as to sentence. When the prosecution breached this promise and urged the maximum sentence, the Supreme Court granted remedial relief, *i.e.*, it

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 vacated the sentence and left it to the trial court either to resentence the defendant or to permit a withdrawal of his guilty plea. Dismissal of the charges was not even suggested.

In *United States v. Payner*, Cr. 76-305 (N.D. Ohio, April 28, 1977), cited by the District Court, IRS special agents obtained evidence against the defendant by "covert" activities, including illegal searches and theft of evidence. Despite findings that such activities were "outrageous," "either purposefully illegal or motivated by an intentional bad faith hostility to a constitutional right," and in violation of the Due Process Clause, the Court did not even consider dismissing the indictment. Troubled by the fact that the defendant lacked standing to invoke the exclusionary rule, the Court concluded, only after extensive discussion, that suppression of illegally obtained evidence was appropriate and could be granted under the supervisory power.

Again, in *United States v. Tweel*, 550 F. 2d 297, 299 (5th Cir. 1977), relied on by the Court below, an IRS agent obtained evidence from the defendant by engaging in a "sneaky deliberate deception" of the defendant and his attorney about the existence of a pending criminal investigation of the defendant. Yet, the Court did not even allude to dismissal as a possible remedy. Instead, it ordered suppression of the evidence—relief remedial in nature.

To be sure, the exercise of the supervisory power has on occasion resulted in dismissal of an indictment, but only where dismissal has been the sole remedy that could restore the defendant to the position he would have occupied but for the illegal conduct. Thus, in *United States v. Jacobs*, 547 F. 2d 772 (2d Cir. 1976), *cert. granted*, — U.S. —, 45 U.S.L.W. 3777 (1977), heavily relied upon by the District Court, no remedy other than dismissal of perjury charges was available to a grand jury witness who had not been given "target warnings," since, had the warnings been given, the witness might not have testified. Also, in *United States v. Estepa*, 471 F.2d 1132 (2d Cir. 1972), the Grand Jury might not have voted the indictment had it not been misled by the prosecutor. Therefore, dismissal was the only possible relief remedial in nature.

Similarly, in *United States v. Orman*, 417 F. Supp. 1126, 1138 (D. Col. 1976), a case replete with aggravated misconduct by DEA agents, the District Judge stated: "No order I can frame will protect defendant against prejudice resulting from the reprehensible violation of her Sixth Amendment rights by Drug Enforcement Administration agents [eavesdropping on attorney-client communications]."

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escape prosecution for serious crimes in a case where it is clear beyond any doubt that, even if the SEC had disclosed to the defendants the criminal reference, they would still be facing precisely the same criminal charges.

The non-remedial nature of the relief ordered below is apparent from the District Court's own factual findings: The Court found that, on December 1, 1975, while settlement negotiations in the SEC civil case were pending, SEC representatives informally referred the defendants' case to the United States Attorney's Office for consideration of prosecution. Thereafter, as the settlement negotiations continued, the SEC representatives wrongfully failed to advise defendants' counsel that the criminal reference had earlier been made.

Thus, while the SEC's failure to disclose the criminal reference might conceivably have affected the defendants' willingness to accept the terms of the civil settlement, it did not in any way aid or affect the grand jury investigation. This is so because the SEC's misconduct came *after* the criminal reference had been made, and because defendants did not rely in any manner detrimental to their rights as accused on the SEC's failure to advise them of the reference.*

[Footnote continued from previous page]

Similarly, in *United States v. Rodman*, 519 F. 2d 1058 (1st Cir. 1975), the defendant made incriminating statements of an extensive nature in reliance upon an express promise from SEC representatives that they would "strongly recommend" against indictment. Once the District Court found that the SEC had violated its express promise, the Government consented to suppression of the defendants' statements made in reliance on the promise. This consent to suppression, however, did not eliminate the likelihood that, had the SEC fulfilled its promise to urge against prosecution, no indictment would have been brought. Moreover, the Government's concession did not eliminate the possibility that its case had been tainted by prior use of the defendant's statements.

* Defendants did not testify at the SEC, nor did they provide privileged documents of any kind.

The "windfall" given to the defendants by the District Court is far from satisfactory, since dismissal of the criminal charges permits the defendants to avoid a criminal prosecution which is in no sense a consequence of the SEC's wrongful conduct. It is further unsatisfactory because dismissal frustrates the public interest in prosecuting these defendants for their blatantly fraudulent activities.

There is, moreover, an alternative remedy which would satisfy the mandate of the Supreme Court that equitable remedies should "as nearly as possible . . . restore the victims of illegal conduct to the position they would have occupied in the absence of such conduct." Had the District Court simply vacated, with prejudice, those portions of the civil settlement which remain to be performed by the defendants, the defendants would have been placed in at least as good a position as they would have occupied in the absence of the SEC's wrongful conduct. To fully explain this argument, it is necessary to review briefly the extremely weak litigating position the defendants found themselves in during the civil settlement negotiations.

In December 1975 and early 1976, the SEC had a motion pending in the civil action for a preliminary injunction and other relief. Absent a settlement, it would have been necessary for the defendants either to file responsive affidavits or to default. (Tr. 1564-67). To contest the SEC's charges, the defendants would have had to dispute *the very facts which their attorneys had disclosed to the SEC* approximately one year earlier in January 1975. Yet they obviously could not do so in good faith. Just as defense counsel had asserted the Fifth Amendment on behalf of his clients Fields, Friedman, and Davis during the SEC investigation, he clearly would not have permitted them to contradict the statements he

had already made to the SEC on their behalf. And the defendants' invocation of the Fifth Amendment privilege would virtually have compelled adverse inferences against them in the civil action. *SEC v. Stewart*, 476 F.2d 755 (2d Cir. 1973); *SEC v. Kelley Andrews & Bradley, Inc.*, 341 F. Supp. 1201, 1205 (S.D. N.Y. 1972); *In re Sterling Harris Ford*, 315 F.2d 277 (7th Cir. 1963); VIII Wigmore, § 2272 at 439 (1961 ed.).

In addition to the fact that the defendants had no real ability to defend against the SEC complaint, the defendants would have faced substantial risks from refusing to settle and continuing to litigate. The SEC might well have pressed its discovery and its investigation into additional transactions, *e.g.*, the price manipulation scheme alleged in the Indictment, which could only have increased the risk of a substantial judgment unfavorable to the defendants. On the other hand, the defendants had little to gain by seeking discovery against the SEC, since, having disclosed the facts to the SEC in the first instance, they already knew what the SEC could prove.

Moreover, if the defendants suffered an adverse judgment, or if they chose to default, they would also have risked penalties even more severe than the ones to which they consented. While the terms of the settlement went far towards repairing the harm caused by the defendants, it is not at all clear that the Court would have been more lenient than the SEC, in view of the egregious nature of defendants' conduct. The Court (i) might not, for example, have allowed the defendants 30 months to pay their monetary liability as the SEC permitted, (ii) might have appointed a receiver for TDA, and (iii) might have removed Fields and Friedman permanently from their positions as officers and directors.

None of these considerations compelling the defendants to settle would have been altered by the defendants' knowledge of the criminal reference. Therefore, we submit, the civil settlement would have been much the same regardless of full disclosure of the criminal reference. Armed with the knowledge of the criminal reference, the defendants' strategy in the civil case inevitably would have been virtually identical, *i.e.*, to negotiate concessions from the SEC (i) that Fields and Friedman could remain as officers of TDA in order to preserve their generous sources of income, and (ii) that the time for payment of the monetary liability could be delayed. As Fields testified, "we knew from Day 1 that we were going to be entering into a consent." (App. 497).

Accordingly, since the civil settlement would have been much the same regardless of disclosure by the SEC, it follows *a fortiori* that a remedial order vacating the unperformed portions of the civil judgments would produce a result more favorable to the defendants than any they could have hoped to achieve in the absence of the SEC's misconduct. In the first place, the consent judgments were not onerous, particularly as to Fields and Friedman, whose out-of-pocket monetary liability has been completely reimbursed by TDA in the form of salary increases, bonuses and a "one time" retroactive "cost of living" increase and whose restrictions on voting have been mooted by the convenient fact that no shareholder votes have been taken since 1975. Indeed, it is easy to imagine the laugh these two defendants must have enjoyed at being congratulated by their Board of Directors for having "always acted with total integrity and selflessness in the Corporation's interest." (App. 188).

In the second place, vacating the judgments at this time would substantially reduce the defendants' civil liabilities, since there is a good deal of the judgments which remains unperformed. Thus, Fields and Friedman would

each be relieved of the obligation to pay an additional \$101,375, and Davis would be relieved of his obligation to pay another \$60,000. Such relief would give defendants a reduction of approximately one-half to two-thirds of the financial liability to which each had originally agreed. See pp. 12-13, *supra*.

The District Court did give passing consideration to the remedy of completely undoing the civil settlement, but erroneously failed to consider modifying it. Thus, the District Court rejected a reopening of the civil settlement, because it assumed that such a remedy would have required the shareholders of TDA to give back moneys already paid by the defendants—a prospect that the District Court found unappealing.* (App. 74). But our proposed modification of the civil settlement does not require that the settlement be entirely undone; rather it requires only that unperformed portions of the settlement be vacated. Therefore, TDA and Westcalind would be permitted to retain moneys already paid, and the defendants would be placed in a far better position than they would ever have occupied with respect to their civil liability.

We have discovered only two plausible, though deficient, explanations for the District Court's failure to consider modifying the civil settlement. The first is that when the Government argued that, even if disclosure had been made, the defendants would have had no option but to agree to the same settlement terms, the District Court rejected this contention *and stated that the SEC was estopped from advancing it*. (App. 58-59). The District Court's conclusion is erroneous for two reasons. First, even if the District Court were convinced that, had the defend-

* There is nothing in the record to suggest that the money the defendants "disgorged" was distributed to shareholders; rather, the money was paid to the corporations.

ants known of the criminal reference, they could have done somewhat better in negotiating a civil settlement, this view is no answer to our contention that the defendants could not have done better than the modification we propose. Moreover, the District Court's finding that "the SEC" is estopped from making any argument that the terms of the civil settlement would have been much the same—with or without disclosure—is incomprehensible. The SEC was not a party to this case, and certainly there was no reason to estop the United States Attorney from presenting arguments about appropriate remedies. Indeed, this so-called estoppel has prevented the District Court from following the dictates of the Supreme Court that equitable remedies must so far as possible restore defendants to the position they would have occupied but for the misconduct.

The second possible explanation for the District Court's failure to consider modification of the civil settlement is that the Court found that "it is impossible . . . to restore the individuals concerned to the positions in which they found themselves [prior to the settlement]." (App. 74). This observation, too, is wide of the mark. Even with disclosure of the criminal reference, the defendants could not have completely avoided liability in the civil case. It was entirely inappropriate, therefore, to attempt to restore the defendants to the position they would have occupied in the absence of any settlement or judgment whatsoever. Relief sufficiently remedial in nature was available by vacating the unperformed portions of the civil judgments.*

The District Court's concern about its inability to restore the defendants to the *status quo ante* was par-

* Moreover, in any event, equitable remedies need not exceed what is fair and workable, *Franks v. Bowman Transportation Co.*, *supra*, 424 U.S. at 777, n. 39; and should not be prejudicial to the public interest, *United States v. Dern*, 289 U.S. 352, 360 (1933).

ticularly evident in its discussion of the situation of defendant Davis, who "resigned from his law partnership and saw his practice come to a virtual end, as the direct consequence of the SEC's bargained-for withdrawal of Davis from practice before the Commission." (App. 75). The Court apparently lost sight of the fact that this detriment suffered by Davis does not require a remedy unless it resulted from the SEC's misconduct. Once again, the result was inevitable, and could not have been prevented with knowledge of the facts in reference. The disclosures which Davis' own attorneys had made to the SEC revealed Davis to be a disbarred attorney. His consuming greed had led him to participate in a variety of frauds in violation of many of the federal criminal statutes he had once sworn to support. In light of these vicarious admissions of his attorneys, Davis was clearly going to be forced to resign his practice before the SEC regardless of what other settlement terms might be agreed to, and whether or not a criminal reference was to be made. Moreover, absent the civil settlement, Davis would have been a defendant in the SEC civil action, the respondent in an SEC administrative proceeding to bar him from practice before that agency, and a defendant in the instant criminal proceeding. It stretches credulity to suggest that Davis could have long retained his law partnership and his clients in such circumstances, particularly since his attorneys conceded to the SEC his illegal participation in fraudulent activities.

B. The District Court's Order Violates the Principle That Equitable Relief Should Be Determined by the Nature and Scope of the Unlawful Conduct

The second principle violated by the District Court's order is that equitable remedies are "to be determined by the nature and scope of the . . . violation," *Milliken v. Bradley*, *supra*, 45 U.S.L.W. at 4877, and therefore should

be directed at the governmental unit responsible for the unlawful conduct. *Id.*

1. The District Court's Remedy Was Misdirected

It is clear that any impropriety in this case is attributable solely to the actions of a small number of SEC representatives. The Judge found "no fault with the actions of any member of the office of the United States Attorney" and that "[t]he impropriety . . . is confined to representatives of the SEC." (App. 82). Yet dismissal of the criminal charges does little to penalize the SEC—an agency which has only civil jurisdiction. Rather, dismissal of the criminal charges penalizes the public by nullifying the work of the Grand Jury and the United States Attorney's Office, both of which were entirely blameless in this matter.

The District Court's explanation for the misdirection of its remedy was as follows:

"[C]onsideration of improper and inequitable behavior is not limited to the confines of the prosecutor's office. It is Government, in all its offices and functions, which must be held to standards of fair and honest dealing with the citizens of the Republic" (App. 82).

While it is true that misconduct of an agency other than the Department of Justice has, on occasion, barred or limited a criminal prosecution, the vicarious liability imposed by the District Court in this case is unlike any other case we have found and constitutes a wholly unwarranted extension of existing doctrine. In cases where courts have held prosecutors responsible for the actions or knowledge of employees in different government agencies, responsibility has been imputed on the ground that the particular agents or employees involved were so intimately associated with the investigation and prosecu-

tion that they were literally "an arm of the prosecutor." *United States v. Morrell*, 524 F.2d 550, 555 (2d Cir. 1975); *United States v. Sutton*, 542 F.2d 1239 (4th Cir. 1976); *Boone v. Paderick*, 541 F.2d 447 (4th Cir. 1976), *cert. denied*, — U.S. — (1977); *United States v. Bryant*, 439 F.2d 642 (D.C. Cir. 1971); *Smith v. Florida*, 410 F.2d 1349 (5th Cir. 1969); *Barbee v. Warden*, 331 F.2d 842 (4th Cir. 1964). Indeed, this Court has expressly declined to impute responsibility in situations where the relationship of the agent to the prosecutor was not sufficiently close. *United States v. Stassi*, 544 F.2d 579, 582 (2d Cir. 1975); *United States v. Stofsky*, 527 F.2d 237, 244, n. 7 (2d Cir. 1975); *cf. United States v. Quinn*, 445 F.2d 940, 944 (2d Cir.), *cert. denied*, 404 U.S. 850 (1971).

Moreover, in addition to a showing of intimate association between prosecutor and agent, a demonstration of prejudice to the defendant's rights as an accused has been required before relief is deemed appropriate. *E.g.*, *Giglio v. United States*, 405 U.S. 150, 154 (1975) (to obtain relief from Government's failure to disclose a promise of leniency to a key witness, defendant must establish that there was a reasonable likelihood that disclosure would have affected the judgment of the jury); *United States v. Agurs*, 427 U.S. 97, 112-13 (1976) (to obtain relief from Government's failure to produce ordinary "discovery" materials, defendant has an even heavier burden of showing that the undisclosed material would have created a reasonable doubt that did not otherwise exist).*

* The cases relied upon by the District Court for the proposition that "conduct of members of Government agencies other than the Department of Justice, or a United States Attorney's office may operate to bar subsequent criminal prosecution," *United States v. Rodman*, *supra*, 519 F.2d 1058; *United States v. Orman*, *supra*, 417 F. Supp. 1126; *United States v. Tweel*, *supra*, 550 F.2d 297; and *United States v. Payner*, *supra*, are easily distinguishable from the present case. In *Orman*, *Tweel*, and

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Clearly, there is little basis for imputing the misconduct of the SEC in a civil proceeding to the United States Attorney or the Grand Jury. The SEC is unlike other federal enforcement agencies such as the FBI or DEA which have no civil functions and which exist solely as investigative arms of the prosecutor. Instead, the SEC has only a civil jurisdiction and concentrates on civil enforcement of the securities laws.* In addition, it is, we submit, most significant that the SEC's failure to disclose the criminal reference, as the District Court found (App. 57-58), was directed at fostering its own civil settlement, not at assisting the United States Attorney or the Grand Jury.

But even more importantly, there was no need for the District Court to stretch beyond recognition the principles of vicarious prosecutorial responsibility for wrongful acts of other agencies. This was so, because a modification of the SEC's civil settlement—a remedy that would have satisfied all of the well-settled principles of remedial

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Payner, DEA and IRS agents acted as an arm of the prosecutor; and in all four cases there was clear prejudice to the defendants in their *criminal* cases. Moreover, as demonstrated *supra* at 20-21, the relief granted in each of these four cases, unlike here, was truly remedial in nature. Indeed, in *Payner* and *Tweel*, the relief ordered was suppression, not dismissal.

* Of course, the SEC may recommend to the Department of Justice that criminal prosecution be considered in particular cases, but it is totally unlike other enforcement agencies such as the FBI, the DEA, or even the IRS, which are charged with the duty of investigating and developing cases for criminal prosecution. The SEC's criminal references are merely incidental to its civil enforcement program. Indeed, in recent years the SEC has largely abandoned its earlier practice of submitting a detailed, written "criminal reference report" to the Department of Justice. Now, the SEC typically forwards its civil pleadings to the appropriate United States Attorney, and leaves it totally to the independent judgment of the prosecutors as to whether or not a grand jury investigation should be commenced. App. 56-57, 205).

relief—would have been directed at the party at fault. Such a result would also have had the salutary effect of deterring future misconduct by alerting the SEC to the fact that its own settlements will be overturned in consequence of any future misconduct.

2. The SEC's Failure to Disclose the Criminal Reference Did Not Warrant a Broad Sanction

It is also important in assessing whether the District Court's remedy was justified "by nature and scope of the . . . violation" to recognize that the SEC representatives did not breach any constitutional or statutory duty. While we do not seek to defend deceptive behavior, it should be recognized that the SEC's duty "to advise counsel immediately that a criminal reference had been made" was announced for the first time in this case.* Thus, the violation cannot fairly be regarded as long-standing, pervasive or likely to continue. The nature and scope

* It is not surprising that no court has previously imposed such a duty. The concealment of a criminal reference from potential criminal defendants is an important safeguard against destruction of documents, subornation of perjury, and intimidation of witnesses, particularly in cases such as here where the proof at trial will show that defendants have demonstrated a willingness to employ threats of violence to serve their criminal purposes. (Letter to Hon. Charles S. Haight, Jr., from United States Attorney's Office, dated March 18, 1977). Less violent means of obstruction—such as collusion and convenient loss of recollection—is also to be feared and best avoided by maintaining secrecy. In addition, in some cases, flight of the potential defendants may also be a problem. These considerations far outweigh any right or interest of a defendant in knowing of a criminal reference, since he is protected by all of the due process and other safeguards built into the criminal justice system. Cf., *SEC v. National Student Marketing Corporation*, 538 F.2d 404, 407 (D.C. Cir. 1976), cert. denied sub nom, *White & Case v. SEC*, 429 U.S. 1073 (1977).

of the violation do not, therefore, call for the extreme measures employed here.*

C. The District Court's Order Violated the Principle That Equity is Unavailable to a Litigant with Unclean Hands

The third principle violated by the District Court's order is that equitable relief is not granted to litigants with "unclean hands."

When the defendants went to the SEC in the first instance, they did *not* do so as volunteers or because their consciences were bothered. Rather, they raced over to the SEC ahead of the District Attorney, calculating that they might improve their position by disclosing the violations to the SEC themselves.** The defendants were then careful, however, to disclose only as much as the District Attorney knew. They did not disclose to the SEC the attempt by Fields and unindicted co-conspirators artificially to inflate the price of TDA's stock immediately prior to the November 1971 public offering. The defendants' attempt to deceive the SEC about the extent of their

* It should also be noted in this regard that the SEC has begun its own investigation to determine whether internal sanctions should be imposed against the SEC representatives involved in this case. (App. 128).

** The defendants did not, of course, come to the United States Attorney's Office, where a definitive answer could have been given as to defendants' exposure to criminal prosecution. Rather, they sought to prevent the United States Attorney from learning of the case by maneuvering at the SEC.

wrongdoing should itself be a bar to equitable relief of any kind, let alone the windfall they have been so charitably awarded here.*

In *Precision Co. v. Automotive Co.*, 324 U.S. 806, 814 (1945), the Supreme Court stated that the unclean hands doctrine "closes the doors of a court of equity to one tainted with inequitableness or bad faith relative to the matter in which he seeks relief, *however improper may have been the behavior of the defendant.*" (emphasis supplied). Accord, *Keystone Co. v. Excavator Co.*, 290 U.S. 240 (1933).

Where granting a claim for equitable relief would adversely affect important public interests, the unclean hands doctrine assumes even greater importance:

"For if an equity court properly uses the maxim to withhold its assistance in such a case it not only prevents a wrongdoer from enjoying the fruits of his transgression but averts an injury to the public."

S. & E. Contractors, Inc. v. United States, 406 U.S. 1, 15 (1972), quoting from *Precision Co. v. Automotive Co.*, *supra*. Accord, *Morton Salt Co. v. Suppinger Co.*, 314 U.S. 488, 492-94 (1942).

The equitable relief afforded these defendants allows them to escape a prosecution plainly required in the public interest. Their own inequitable behavior should prevent them from seeking any of the benefits of equity.

* The District Court did find that the defendants could not obtain dismissal of any charges premised on the price manipulation, since such charges were developed independently by the Grand Jury. (App. 75). But this decision gave no effect to the well-settled doctrine that "unclean hands" bars a litigant's right to relief from a court of equity at all. *Precision Co. v. Automotive Co.*, 324 U.S. 806, 814-15 (1945).

D. Conclusion

The Supreme Court has recently been careful to give full effect to the Executive's duty to enforce the federal criminal laws by dispelling any suggestion that the judiciary possesses a "chancellor's foot" veto over law enforcement practices of which it [does] not approve." *United States v. Russell*, 411 U.S. 423, 435 (1973); see also *Hampton v. United States*, 425 U.S. 484, 490-91 (1976) (plurality opinion); *id.* at 494 (Powell J., concurring). The Supreme Court has also recently declined to afford to criminal defendants relief from violations of their rights as accused disproportionate to the prejudice suffered in their criminal cases from these violations. See *Weatherford v. Bursey*, 429 U.S. 545, 557-58 (1977); *Hampton v. United States*, *supra* at 490; *United States v. Russell*, *supra*.

It is indeed ironic therefore that the District Court here reached out in an unprecedented fashion to dismiss criminal charges where the SEC's misconduct caused the defendants *no prejudice whatsoever in their criminal case*. The District Court's decision is all the more unfortunate, since full and fair alternative relief could have been ordered, and since the effect of the dismissal is to thwart the public interest by precluding prosecution of flagrant violations of the federal securities laws.

Aside from the opinion below, we have found no authority supporting the conclusion that a defendant may obtain a dismissal of criminal charges where the misconduct of a government agency has no effect at all on the defendant's rights as an accused. We submit that the reason no such authority can be discovered is that the result would be both illogical and ill-advised. We therefore respectfully submit that the District Court's dismissal here of criminal charges based on SEC mis-

conduct should be reversed and an alternative remedy vacating the unperformed portions of the civil settlement should be substituted.

POINT II

The ERD kickbacks should be reinstated in Counts One, Two, and Three, since they should have been disclosed in the prospectus.

As an alternate ground for dismissal of those portions of Counts One through Three of the Indictment relating to the ERD transactions, described in paragraphs 10(f)-(h) of the Indictment, the District Court ruled that the ERD allegations failed to state an offense. (App. 83-87, 115). This ruling is a grave error with unfortunate implications for future enforcement of the securities laws.

To put the District Court's decision in perspective, it is necessary to review briefly the charges found in Counts One, Two and Three. Counts One and Two charge that the defendants conspired to and did defraud purchasers of securities in violation of § 17 of the Securities Act of 1933 (15 U.S.C. § 77q(a)).* These Counts

* Section 17 provides:

(a) It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

charge that one of the means employed by the defendants in their fraudulent scheme was to issue a prospectus for a public offering of TDA common stock in November 1971 which was false and misleading because it failed to disclose certain "material facts." Count Three charges the defendants with having filed with the SEC a prospectus which concealed and covered up "material facts" in violation of 18 U.S.C. § 1001.*

Among the "material facts" alleged to have been omitted from the prospectus in each of these three counts were the ERD kickbacks of April and May 1971. (Indictment ¶¶ 10(f) through 10(h)). In these transactions, defendants Fields, Friedman, and Davis defrauded a group of TDA stockholders out of \$435,000, by refusing the request of these stockholders to "free-up" their unregistered TDA stock for sale on the open market, and by falsely representing that the stock could only be transferred in a private placement. Then, the defendants arranged a private placement at a \$2 per share discount from the market price, concealing from the selling stockholders that, by pre-arrangement, the shares would immediately thereafter be "freed up" and sold on the open market, and that 70% of the gross profits would be kicked back to the defendants.

While viewing the defendants' participation in the ERD kickbacks to be "reprehensible" and to consist of

* Section 1001 provides:

Whoever, in any matter within the jurisdiction of any department or agency of the United States knowingly and willfully falsifies, conceals or covers up by any trick, scheme, or device a material fact, or makes any false, fictitious or fraudulent statements or representations, or makes or uses any false writing or document knowing the same to contain any false, fictitious or fraudulent statement or entry, shall be fined not more than \$10,000 or imprisoned not more than five years, or both.

"blatant instances of the kind of over-reaching condemned by our securities laws" (App. 85), the District Court nevertheless concluded that, insofar as Counts One, Two and Three alleged that the omission from the prospectus of the ERD kickback scheme constituted an unlawful withholding or concealment of "material facts," the allegations were insufficient to state an offense. The basis of the District Court's decision was that:

"[T]hese [ERD] transactions did not in any discernible way bear upon the financial condition of the company whose shares were being publicly marketed. That is, defendants' ill-gotten gains had not been at the expense of TDA, and consequently the failure to disclose such manipulations was not relevant to a purchaser's informed decision on the merits of investing in the company. Neither the indictment nor the Government's memorandum of law contain any indication of how the ERD transactions could have reflected upon the *company's* true financial status, nor is any effect implicit from the nature of those dealings. . . ."

At most⁺ the nondisclosures of the ERD schemes deprived investors of the knowledge that certain TDA directors and officers had larceny in their hearts. However, Section 17 cannot be read so broadly as to require the inclusion of character profiles of key personnel in each prospectus. Defendants' counsel adduce many learned cases indicating that such revelation is beyond the limited scope, purpose and mission of Section 17; no discussion of such authority is necessary here since

* While it is true, as the District Judge states, that the Government did not indicate below "how the ERD transactions could have reflected upon the *company's* true financial status," the defendants did not advance this theory of materiality, nor was it the subject of any oral argument.

to state the proposition is to recognize its invalidity." (App. 85-86).

The District Court did not—and could not—provide any citation of authority for its restrictive conception of materiality. Materiality is not limited, as the District Court concluded, to transactions bearing upon the company's true financial status. *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976). There, the Supreme Court discussed the standard of "materiality" at length, and provided the following formulation:

"An omitted fact is material if there is a substantial likelihood that a reasonable [investor] would consider it important in deciding [whether to purchase or sell securities] . . .

Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." 426 U.S. at 449.

Although the *TSC* case was brought under § 14(a) of the Securities Act of 1934 for alleged material omissions from proxy materials, the standard of materiality is and has long been, essentially the same under all sections of the securities laws. *TSC Industries, Inc. v. Northway, Inc.*, *supra*, at 445 n.8; *Affiliated UTE Citizens v. United States*, 406 U.S. 128, 153-54 (1972); *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 384 (1970); *Alton Box Board Co. v. Goldman, Sachs & Co.*, CCH Fed. Sec. L. Rptr. ¶ 96,127, at 92,068 (8th Cir., Aug. 10, 1977); *Smallwood v. Pearl Brewing Co.*, 489 F.2d 579, 603-04 (5th Cir. 1974); *Ronson Corp. v. Liquifin Aktiengesellschaft*, 483 F.2d 846, 851 (3d Cir. 1973); *Gerstle v. Gamble Skogmo, Inc.*, 478 F.2d 1281, 1301-02 (2d Cir. 1973); *Kohn v. American Metal Climax, Inc.*, 458 F.2d 255, 269 (3d Cir. 1972); *General Time Corp. v. Talley Industries, Inc.*, 403 F.2d 159, 162 (2d Cir. 1968), *cert. denied*, 393 U.S. 1026

(1969); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968), *cert. denied sub nom. Coates v. SEC*, 394 U.S. 976 (1969); *List v. Fashion Park, Inc.*, 340 F.2d 457, 462 (2d Cir.), *cert denied sub nom. List v. Lerner*, 382 U.S. 811 (1965). In applying this standard, the courts have found many material omissions which do not bear in any way upon the financial condition of the issuer. *E.g.*, *SEC v. Parklane Hosiery Co., Inc.*, CCH Fed. Sec. L. Rptr. ¶ 96,108, at 91,994-95 (2d Cir., July 8, 1977) (failure of majority shareholder to disclose his reasons for "going private"); *SEC v. Falstaff Brewing Corp.*, CCH Fed. Sec. L. Rptr. ¶ 96,117, at 92,022-23 (D.D.C., Aug. 1, 1977) (failure to disclose enhancement of control that would result from proposed stock dividend); *SEC v. Rapp*, 304 F.2d 786, 791 (2d Cir. 1962) (failure to disclose that salesman was a principal).

In our view, nothing could have been more "material" to potential TDA investors than to know that, only five months earlier, other investors in TDA had been cheated out of \$435,000 by the company's president and financial vice-president, and by the company's attorney. A reasonable investor surely would have found that disclosure of the ERD kickbacks "significantly altered the 'total mix' of information made available." *TSC Industries, Inc. v. Northway, Inc.*, *supra*, 426 U.S. at 449. This is so first because the \$435,000 profit obtained in the defendants' scheme was in effect an uncollected asset of TDA, since it resulted from "short swing" trades "recoverable by the issuer." § 16(b), Securities Exchange Act of 1934 (15 U.S.C. § 78p(b)); see *Foremost McKesson, Inc. v. Provident Securities Co.*, 423 U.S. 232, 243-44, 251 (1976).*

* Section 16(b) of the Securities Exchange Act of 1934 provides in pertinent part that "any profit realized by [any director or officer of the issuer] from any purchase and sale, or any sale and purchase, of any equity security of such issuer . . . within any period of less than six months . . . shall inure to and be recoverable by the issuer." Suit to recover such profit may be brought

[Footnote continued on following page]

The defendants' unlawful conversion of \$435,000 in corporate funds therefore dramatically depleted TDA's corporate treasury.*

Second, potential investors would surely have wanted to consider the undoubtedly adverse consequences to the corporation of the defendants' misdeeds. When corporate officers demonstrate a willingness to cheat the corporation's own shareholders and a complete disregard of the securities laws,** investigation by the SEC and the United States Attorney is likely to follow. Such an investigation can result in SEC enforcement actions and criminal prosecution, both against individual officers and directors and against the corporation itself. In addition, other Government agencies such as IRS might become involved as well, resulting in further expense to the corporation from tax audits and possible tax penalties.

[Footnote continued from previous page]
by the corporation or by any shareholder derivatively. § 16(b). The statute imposes "liability without fault" with respect to insider, short-swing trading. *Foremost-McKesson v. Provident Securities Co.*, *supra* at 251.

The ERD kickbacks involved the following "short swing" trades by defendants: the purchase and sale *on the same day* of 90,000 shares of TDA, yielding a profit of \$213,500 (Indictment, ¶ 10(f)(v) - (vi)); the purchase of 123,178 shares of TDA and sale *the following day* of 100,000 shares, yielding a profit of \$193,750 (Indictment ¶ 10(g)(iv)-(v)).

* The District Court was therefore in error when it concluded that "defendants' ill-gotten gains had not been at the expense of TDA, and therefore was not relevant to a purchaser's informed decision on the merits of investing in the company." (App. 86). Thus, even applying the Court's own unduly restrictive definition of materiality, the ERD kickbacks were plainly material.

** The defendants' conduct violated a number of statutes: § 5 of the Securities Act of 1933, 15 U.S.C. § 77e (sale of unregistered TDA securities); § 16(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78p(a) (failure to report "short swing" profits from the sale of the TDA securities); Rule 10b-5 (fraud on selling TDA shareholders in the secondary offering of November 10, 1971).

Moreover, investors must consider that the company's officers may have committed other, as yet undiscovered, violations and that they may have a propensity to commit similar violations in the future. Finally, once creditors, suppliers, and lenders learn of such fraudulent activity, the company would no doubt find raw materials and credit more costly and difficult to obtain.

In sum, it is obvious that the ERD kickback transactions would have weighed heavily in any reasonable investor's decision about purchasing TDA's common stock in the public offering, and thus were "material facts" within the meaning of the statute. In any event, the question of materiality here was certainly not of a sort that should have been withheld from a jury's consideration. *TSC Industries, Inc. v. Northway, Inc.*, *supra*, 426 U.S. at 450.

POINT III

Count Four should be reinstated, since the defendants were required by the proxy rules to disclose the ERD and Westcalind Kickbacks.

Count Four of the Indictment charges defendants Fields, Friedman and Davis with a violation of § 14(a) of the Securities Exchange Act of 1934 (15 U.S.C. § 78n(a)) and Rule 14(a)-9 (17 C.F.R. § 240.14a-9),*

* Rule 14(a)-9 provides:

"(a) No solicitation subject to this regulation shall be made by means of any proxy statement, form of proxy, notice of meeting or other communication, written or oral, containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading."

arising from a proxy statement distributed in December 1971 to TDA shareholders. The matter as to which shareholders' proxies were solicited was the election of corporate directors.*

Count Four charges that the proxy statement omitted material facts pertaining to the qualifications of Friedman for the position of corporate director, namely, the participation of Friedman with the other defendants in (1) the March 1971 Westcalind kickback, and (2) the April and May 1971 ERD kickbacks.

The defendants moved to dismiss this Count on the grounds, *inter alia*, that the alleged omissions were not "material" and that the element of "causation" was lacking, *i.e.*, the transactions complained of were not the subject or result of the shareholders' vote. The District Court granted the motion.**

The Court based this result on the conclusion that a would-be director's duty to disclose prior misdeeds in his proxy solicitation is strictly limited to disclosure of misdeeds involving a "direct depredation of corporate assets by a director." (App. 94-95). Applying this reasoning, the District Court found that the defendants' "stealing" of the \$50,000 "finder's fee" from Westcalind was "too far removed" from the parent company, TDA, to require disclosure of the kickback in the proxy statement sent to TDA stockholders. (App. 124). As to the EDR kickbacks, the Court concluded, without further enlightenment, that they bore no "direct relationship to the business sought to be accomplished at the [shareholders] meetings, and referred to in the proxy statement[s]" (App. 91-92).

* Defendant Friedman was standing for election as a TDA director. The proxy statement also contained a proposal to amend the company's stock option plan.

** The District Court also struck certain of the allegations in Count Five (which relates to the Westcalind proxy statement). (App. 91-92). We do not appeal that portion of the decision below.

In arriving at the conclusion that a would-be director's duty is limited to disclosure of misdeeds involving a direct depredation of corporate assets, the District Court expressly relied on two decisions by Judge Owen, *SEC v. Kalvex, Inc.*, 425 F. Supp. 310 (S.D.N.Y. 1975) and *Levy v. Johnson*, '76-'77 CCH Fed. Sec. L. Rptr. ¶95,899 (S.D.N.Y., Feb. 15, 1977). In *Kalvex*, one of the defendants who solicited proxies for election as a director did not disclose that he had received \$8,500 in kickbacks from one of the corporation's suppliers and had improperly obtained from the corporation reimbursement of personal expenses in the approximate amount of \$1,000 per year for three years. Judge Owen held that these facts should have been disclosed in the proxy statement. In *Levy*, defendants who were seeking election as corporate directors were charged with not disclosing in proxy solicitations that they had previously made "improper payments" to representatives of foreign governments. There, Judge Owen ruled that plaintiffs had failed to state a claim under § 14(a) of the Securities Exchange Act.

The District Court saw "no difficulty in reconciling the decisions in *Levy* and *Kalvex*," stating:

"Where individuals present themselves for election as directors of a corporation, and fail to disclose in proxy solicitations that they have, in effect, been stealing from the very corporation which they desire to continue to 'serve', the necessary element of 'transaction causation' is present, and a violation of Section 14(a) arises. To hold otherwise would make a mockery of the proxy statute and regulations. That is the situation presented by *Kalvex* ... However, prior acts of individuals which are not directly related to the affairs of the corporation are not material within the Section 14(a) context, as a matter of law. That is the teaching of *Levy*, and it is no answer to say that such actions reflect generally upon the character

of the individuals standing for election." (App. 95).*

The District Court, in our view, clearly was in error in concluding that the ERD and Westcalind kickbacks were not required to be disclosed in the proxy statement sent to TDA shareholders.

First, the District Court did not give effect to specific provisions of the Federal Proxy Rules requiring disclosure of the ERD and Westcalind kickbacks in the TDA proxy. In this regard, the District Court failed to recognize a critical distinction between the *Levy* and *Kalvex* decisions which, we submit, correctly explains the different results in those two cases.

In *Kalvex*, Judge Owen found that Item 7 of Schedule 14A of the Proxy Rules, 17 C.F.R. § 240.14a-101, specifically required disclosure of the remuneration obtained by defendants in that case, and of defendants' transactions with the issuer. 425 F. Supp. at 314-15. In *Levy*, however, the improper foreign payments were not required to be disclosed by any provision of the Proxy Rules. See, Schedule 14A, 17 C.F.R. § 240.14a-101.** Thus, the Proxy Rules supply the element of "transaction causation," i.e., the transaction caused is the election of corrupt directors. *SEC v. Kalvex*, *supra*, 425 F. Supp. at 315; *SEC v. Fal-*

* There is some confusion in the Court's opinion, and indeed in the prior decisional law as well, between "materiality" and "transaction causation." See, *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374, 384 (2d Cir. 1974) (concurring opinion).

** The SEC recently moved to amend the Proxy Rules to require disclosure of improper payments to foreign or domestic government officials. SEC Release No. 34-13185 (Jan. 19, 1977) proposing amendment to Item 6 of Schedule 14A, 17 C.F.R. 240.14a-101, reproduced at [Vol. 2] CCH Fed. Sec. L. Rptr. ¶ 24,037, at 17,583.

staff Brewing Corp., supra, CCH Fed. Sec. L. Rptr. ¶ 96,117 at 92,018, 92,023.*

Applying the Proxy Rules to Count Five, it is apparent that the defendants omitted to state facts required by Item 7 of Schedule 14A, 17 C.F.R. § 240.14a-101. Item 7(e)(4) specifically requires disclosure of any "indebted[ness] to the issuer . . . of [e]ach director or officer of the issuer . . . [including] any indebtedness [which] arose under Section 16(b) of the [Securities Exchange] Act . . ." As already seen in Point Two, *supra* at p. 39, the ERD kickbacks constituted "short swing" trades within the meaning of Section 16(b), and the defendants' \$435,000 profit was therefore owed to TDA. Accordingly, the ERD kickbacks should have been disclosed in the defendants' proxy solicitation.

In addition, Item 7(f) of Schedule 14A specifically requires disclosure of:

"any transactions since the beginning of the issuer's last fiscal year . . . to which the issuer or any of its subsidiaries was or is to be a party, in which any of the following persons had or is to have a direct or indirect material interest . . .

(1) Any director or officer of the issuer; (2) Any nominee for election as a director . . ." (emphasis supplied).

* In cases where non-disclosure of a would-be director's prior misdeeds has been held not to constitute a proxy violation, there has been no specific proxy rule requiring such disclosure. See *Limmer v. General Telephone & Electronics Corp.*, CCH Fed. Sec. L. Rptr. ¶ 96,111 (S.D.N.Y., March 21, 1977); *Lewis v. Elam*, CCH Fed. Sec. L. Rptr. ¶ 96,013 (S.D.N.Y., Apr. 5, 1977); *Walner v. Friedman*, 410 F. Supp. 29 (S.D.N.Y. 1975); *Epic Enterprises, Inc. v. man*, 410 F. Supp. 773 (N.D. Okla. 1975); *Robbins v. Banner Industries, Inc.*, 285 F. Supp. 758 (S.D.N.Y. 1966).

It is clear that the Westcalind kickback should have been disclosed under this provision of the Proxy Rules, since Westcalind, a TDA subsidiary, paid a \$50,000 "finder's fee" in which the defendants had a \$35,000 interest.

The materiality of the Westcalind and ERD kickbacks to the TDA proxy solicitation is, moreover, easily established by reference to the standard enunciated by the Supreme Court in *TSC Industries, Inc. v. Northway, Inc.*, *supra*, 426 U.S. at 449:

"The general standard of materiality that we think best comports with the policies of Rule 14a-9 is as follows: An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote . . . It does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote. What the standard does contemplate is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder."

As to the ERD kickbacks, "[t]o ask this question is to answer it." *SEC v. Kalvex, Inc.*, *supra*, 425 F. Supp. at 315. Obviously, defendants' "theft" of \$435,000 from TDA "would have assumed actual significance in the deliberations of the reasonable shareholder" of TDA as to whether Friedman should have been continued as a director.

Turning to the Westcalind kickback, disclosure in the TDA proxy statement that the defendants had siphoned off \$50,000 from Westcalind—a TDA subsidiary—for their personal use by means of a phony finder's fee again clearly "would have assumed actual significance in the deliberations of the reasonable shareholder" of TDA in connection with such a shareholder's decision to vote for

defendant Friedman. To hold otherwise is, we submit, totally unrealistic.*

But even if the District Court's mistaken standard for disclosure were to be applied, the omission of the ERD and Westcalind kickbacks in the TDA proxy would constitute an offense. The District Court believed that a proxy rule violation could only be found if the omitted transaction constituted a "direct depredation of corporate assets by a director." The ERD kickbacks, as we have previously discussed, were just such a depredation. See p. 39, *supra*. Moreover, since TDA was the controlling shareholder in Westcalind, the "Westcalind kickback," a clear depredation of that corporation's assets, constituted a direct depredation of TDA assets. Indeed, while the District Court concluded that the "Westcalind kickback" had no impact on TDA's financial condition in the context of deciding whether the "Westcalind kickback" was material to TDA's proxy statement, for reasons best known to the District Judge, he reached the exact opposite conclusion when considering TDA's offering prospectus. In that latter context, the District Court stated:

"[The defendant's argument] apparently follows from the fact that those transactions [the ERD and Westcalind kickbacks], reprehensible though they may be, did not impact on the issuing company's financial condition such that innocent purchasers were lured into investing in a corporation whose true condition had been materially misrepresented to them . . .

"In theory, this point is well taken. It is inapplicable, however, to the Westcalind 'finder's fee' since the \$50,000 commission involved there was paid by the corporation, and represents pre-

* In any event, the issue of materiality should have been left to the jury. *TSC Industries, Inc. v. Northway, Inc.*, *supra*, 426 U.S. at 450.

cisely the kind of self-dealing which debilitates the corporation and thereby misleads purchasers of that company's stock who were unaware of it, e.g., *United States v. Aloï*, 511 F.2d 585 (2d Cir. 1975). (App. 85).

CONCLUSION

The order of the District Court striking paragraphs 10(d)-(h) and 11(e) and dismissing Counts Four through Eleven of the Indictment should be reversed, and the case should be remanded for trial.*

Respectfully submitted,

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* As previously noted, we do not appeal from the District Court's striking of certain allegations in Count Five. See p. 42, *supra*.

Form 280 A - Affidavit of Service by mail

AFFIDAVIT OF MAILING

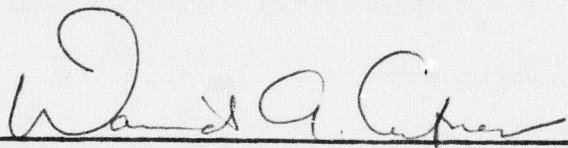
State of New York)
County of New York)

DAVID A. CUTNER, being duly sworn,
deposes and says that he is employed in the office of
the United States Attorney for the Southern District of
New York.

Wae That on the 29th day of September, 1977
he served ~~a copy~~ ^{two copies} of the within Brief
by placing the same in a properly postpaid franked
envelope addressed:

[SEE ATTACHED LIST]

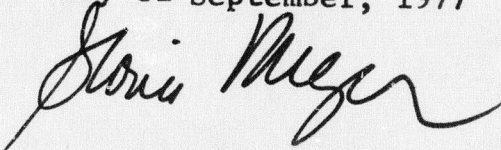
And deponent further says that he sealed the said en-
velope and placed the same in the mailchute drop for
mailing in the United States Courthouse Annex,
One St. Andrew's Plaza, Borough of Manhattan, City
of New York.



DAVID A. CUTNER

Sworn to before me this

29th day of September, 1977



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Notary Public, State of New York
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